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Liability Issues for Audit Firms— The Risk of Catastrophic Exposure Prompts Calls for Liability Reforms

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Civil Claims Against Auditors Continue to Pose Liability Risks

The exposure of audit firms to large claims continues, although in 2005-06 the number of civil class actions alleging accounting fraud seems to have dropped from the levels of prior years,¹ and certainly has declined in relation to the number of accounting restatements reported by public companies in the last 24 months.² The data on how much accounting firms have paid to resolve private litigation and/or regulatory claims is not well compiled, yet there have been a few "mega" settlements in 2006 in which significant settlement payments were made by accounting firms, including several settlements by now-defunct Arthur Andersen.³ Moreover, according to one study released earlier this year, over 90% of all new class action suits filed in 2006 included allegations of false financial statements. The same study reported a sharp increase in the number of cases alleging specific accounting irregularities, from 44% in 2005 to 68% in 2006.⁴

At the same time, however, accounting firms have successfully moved to dismiss a number of class action cases brought against them in the last 24 months, an indication that the PSLRA heightened pleading standards, combined with recent decisions narrowly construing the scope of primary liability under Section 10(b) of the 1934 Act, continue to deter at least some meritless claims against accounting firms.⁵ Further, the United States Supreme Court will soon decide important issues over the liability of "secondary actors" sued under Section 10(b) of the Securities Exchange Act, in a case that is closely watched by the accounting profession.⁶ If the Court affirms the Court of Appeals decision, the rate of securities class action cases against audit firms may diminish further. In the absence of more concrete reforms, however, audit firms no doubt will continue to face the prospect of catastrophic losses.

Contractual Limitations on Auditor Liability

In some cases accounting firms have taken steps to allocate litigation risk by including indemnity agreements in their engagement letters with clients in certain circumstances. Existing American Institute of Certified Public Accountants (AICPA) ethics rules permit such indemnification if, for example, there were knowing misrepresentations by management.⁷

The SEC's position on this matter—at least as reflected in the Staff's answers to "Frequently Asked Questions" in 2004—has been that an accountant's independence may be called into question if the accountant enters into an indemnity agreement with the registrant, if the indemnity purports to provide immunity to the accountant against liability for his or her own negligent acts. Likewise, the SEC has stated that indemnity agreements that protect auditors from liability caused by "knowing misrepresentations by management" may impair independence.⁸

During 2006, the AICPA began a process of reevaluating whether and to what extent audit firms may limit their liability through contractual indemnification agreements with their audit clients. The issue was brought forward most directly in an exposure draft issued by the AICPA's Professional Ethics Executive Committee in September 2005 that would allow auditors to limit liability under certain circumstances. Based on a limited number of comments received, the PEEC issued its proposed Interpretation 101-166 in September 2006. The proposed Interpretation would authorize audit firms to enter into indemnification agreements with their clients only if the audit firm has performed the audit services "in accordance with professional standards, in all material respects."⁹ The proposed Interpretation found that certain other actions, however, would not impair independence, including 1) indemnification for punitive damages claims by third parties, 2) "reasonable" time limitations on when an audit client may sue the auditor, and 3) ADR provisions mandating arbitration of auditor malpractice or other claims.

The proposed Interpretation has been met with mixed reactions from the accounting profession. Several comment letters on the proposed Interpretation were critical of the conditions placed on indemnification, particularly given the vagueness of the "in accordance with professional standards" condition.¹⁰ Hearings on the proposed Interpretation that were supposed to have been held on November 30-December 1, 2006 were taken off calendar.¹¹

Whether agency actions will affect the use of limitation of liability provisions in the future remains to be seen. In the meantime, the overarching issue remains, and audit firms continue to face liability risks without reliable protections against their own audit clients' misconduct.

Looking Ahead

"Paulson Committee" Reform Proposals

On November 30, 2006, the Committee on Capital Markets Regulation—colloquially referred to as the "Paulson Committee"—issued its "Interim Report of the Committee on Capital Markets Regulation" ("Report"), covering various aspects of the regulation of the capital markets, and proposing various regulatory and market reforms. Several of the proposed reforms are directed to the issue of auditor liability. The Report discussed the increasing liability risks posed to the remaining "Big Four" accounting firms, and the possible impairment of consumer choice if one of those firms were to fail. The Report noted in particular that there are more than three dozen cases involving tens of billions of dollars of potential exposure to accounting firms, and expressed the concern that even a relatively small share of proportional liability in these cases may lead to the financial failure of one of the remaining firms. "For the profession itself, there is consensus both inside and out that the demise of one of the remaining Big Four could have adverse consequences for audited companies and their shareholders."¹²

In light of these concerns, the Report suggested several possible reforms:

- Create a safe harbor for certain defined auditing practices.
- Set a cap on auditor liability in certain circumstances.
- Grant regulators specific powers to appoint "monitors" to oversee operations of audit firms found to have engaged in systemic failures in process, management or personnel.
- Clarify and limit an auditor's duties under Section 10A.
- Restrict criminal indictments against firms, as opposed to individual audit partners.

As of the date of this paper, the near-term prognosis for the Report's recommendations is unclear. But recent public remarks by the SEC's Chief Accountant, Conrad Hewitt, suggest that support for some form of liability reform for audit firms is building.¹³ In similar remarks last year on the subject of liability protection for audit firms, Mr. Hewitt is reported to have said that "I definitely think it needs to be looked at."¹⁴

The concept of liability "caps" is being considered by the European Commission as a means of avoiding the failure of any of the major audit firms practicing in the EU. Among the ideas being considered by the European Commission are:

- Fixed monetary caps at the European level;

- Caps based on market capitalization of the audited company;
- Caps based upon a multiple of audit fees;
- Proportionate liability based upon degree of responsibility.

The EC is accepting comments on these ideas as this article goes to press. Charles McGreevy, an EU Internal Market commissioner, voices support for these ideas: “there is a real danger of one of the Big 4 being faced with a claim that could threaten its existence,” he said.¹⁵ The European Commission has established an “Auditors Liability Forum” to consider the issues, comprised of representatives from the Big Four firms, as well as other constituencies. In January 2007, the European Commissions issued a Staff Working Paper on “Auditors Liability and Its Impact on the European Capital Markets,” in which it noted an array of potentially adverse consequences if another Big Four audit firm were to fail, and also the challenges to attracting new audit firms to step forward. The Commission’s Working Paper was largely based upon an independent study by London Economics.¹⁶

Finally, a March 2007 report from the Commission on the Regulation of U.S. Capital Markets in the 21st Century recommends that domestic and international policy makers “seriously consider proposals... to address the significant risks faced by the public audit profession from catastrophic litigation.” The Commission includes representatives from stakeholders from the mutual fund and pension fund industries, as well as financial services firms, the insurance industry, and other important industry representatives. Among other findings, the report states that “sustaining a strong, economically viable, public company audit profession is vital to domestic and global capital markets,” and that this condition is threatened by the current climate of civil litigation and regulatory proceedings against accounting firms.¹⁷ Specific recommendations of the Commission include:

- Focus any criminal indictments on culpable individuals within audit firms, not the firms themselves;
- Create a national charter, similar to the national bank charter, that would confer positive benefits for audit firms by replacing the multiplicity of conflicting state regulations now facing audit firms;
- Include international audit firm liability issues as a topic to be addressed by the Group of Eight (G-8) countries;
- Expand the overall capacity of the audit profession through expansion of the next tier of audit firms below the Big Four;

- Strengthen the ability of audit firms to use arbitration or other ADR solutions instead of litigation in the court system.

Besides these recommendations that are specific to the audit profession, the Commission recommends several other broader litigation reforms, and calls upon the SEC to undertake a thorough review of how the Private Securities Litigation Reform Act has addressed the problem of frivolous shareholder litigation since its passage by Congress in 1995, and whether it is meeting the objectives set by Congress.

The Challenge of “Principles-Based” Accounting

In 2002, as part of the enactment of the Sarbanes Oxley Act, Congress directed the SEC to report on efforts to move U.S. GAAP standards from the detailed “standards based” accounting rules now in place, to a more “principles-based” standard of accounting.¹⁸ In July 2003, the SEC released its initial study on principles-based accounting. The SEC Study largely dismissed the concern over increased litigation risks that a “principals-based” accounting system might create. “We believe . . . that the concern over litigation uncertainty is sometimes overstated and may arise out of a confusion between principles-based and principles-only standards.”¹⁹

Since issuance of the SEC Study, SEC officials have joined with the Financial Accounting Standards Board (FASB) and other market participants to study how to make the nation’s accounting standards less complex.²⁰ In general, “principles based” accounting standards encourages the exercise of accounting judgment, rather than reliance on bright line rules and technical standards. The current GAAP system is based on a myriad of principles, rules, interpretations, and standards. This “standards-based” regime recently was described by former SEC Commissioner Cynthia Glassman as follows:

The financial reporting landscape is littered with pronouncements from the FASB, the AICPA, the EITF, the APB, the SEC and the PCAOB. We have pronouncements, rules, regulations, guides, bulletins, audit standards, interpretations and practice aids in the form of SOPs, FAQs, SABs, Q&As and FSPs. This has been going on for decades. The result today, U.S. GAAP is made up of over 2,000 pronouncements. That’s a lot of ABC’s, even for a CEO or CFO with a CPA.²¹

In contrast to a “standards-based” accounting system, FASB Chairman Robert Herz described “principles-based” accounting this way:

Under a principles-based approach, one starts with laying out the key objectives of good reporting in the subject area and provide them as guidance explaining the objectives and relating it to some common

examples. While rules are sometimes unavoidable, the intent is not to try to provide specific guidance or rules for every possible situation. Rather, if in doubt, the reader is directed back to the principles.²²

Supporters of a principles-based system believe it will foster a more nuanced exercise of accounting judgment. However, certain constituencies have expressed the fear that a “principles based system” may expose them to greater risk of litigation. Without technical standards to point to, these constituents fear that regulators and private plaintiffs’ lawyers will have too much latitude to second guess an accountant’s exercise of judgment.

SEC officials continue to assure the business community that a “principles-based” system will not result in “gotcha” enforcement actions,²³ but a number of senior executives and accounting professionals are still skeptical. According to a recent survey by CFO.com magazine, 36 percent of CFO’s who oppose principles-based accounting cited the risk of major shareholder lawsuits as a reason for concern. “If principles-based accounting is going to work, we need to be presumed to be right,” said one financial executive.²⁴ “The big concern is that we make a legitimate judgment based on the facts as we understand them, in the spirit of trying to comply, and that plaintiffs’ attorneys come along later with an expert accountant who says, ‘I wouldn’t have done it that way,’ and aha! – lawsuit! – several billion dollars, please.”²⁵ “CFO’s are second-guessed by auditors, who are then third-guessed by the Public Company Accounting Oversight Board [PCAOB], and then fourth- and fifth-guessed by the SEC and the plaintiffs’ bar.”²⁶ It is not yet clear that “principles” can stop this pattern of “Monday morning quarterbacking.”

The SEC, the FASB, and the PCAOB all appear to have made principles-based accounting a priority issue for the next year. In 2006, principles-based accounting has been promoted in speeches by SEC Chairman Christopher Cox, SEC Commissioner Paul Atkins, FASB chairman Robert Herz, and former SEC deputy chief accountant Scott Taub.²⁷ On March 23, 2006, for example, Scott Taub, the SEC’s then-acting chief accountant, said that he is “a little disheartened” because the implementation of the new “objectives-oriented standards” “to my mind has not been principles-based.”²⁸ In December 2006, the SEC’s Chief Accountant, Conrad Hewitt, publicly declared that the issue of accounting complexity will be a leading topic of work by his office in 2007.²⁹ PCAOB Director of Registration and Inspection, George H Diacon, recently stated, “we shouldn’t be second-guessing reasonable decisions made in the accounting field, however, PCAOB inspectors should challenge judgments that are not in the ‘reasonable range.’”³⁰

John White, director of the SEC Division of Corporation Finance, recently spoke to this topic. In response to

the question, “what standard is used by Staff to determine when the company has complied with or failed to comply with principles-based regulation?” He said, “We understand that there is not a specific rule out there for every circumstance” and that the Staff will proceed “in good faith.”³¹ FASB Chairman Robert Herz seems to have acknowledged the issue when he remarked that “if it turns out some of the obstacles are hardwired into our structure, then maybe we need some legal changes as well.”³²

Will regulators be willing to consider some form of “safe harbor” for auditors exercising judgment under a new “principles-based” accounting system? At least one recent study urges such a solution. In November 2006, the Committee on Capital Markets Regulation made a number of recommendations for adjustments to our regulatory and litigation framework so that public markets are less burdensome. The Committee expressly recognized that regulators must reduce the risk of litigation to corporations, auditors, and outside directors, and specifically recommended that Congress consider enactment of safe harbors for certain auditing practices.³³

Treasury Secretary Henry Paulson recently stated that auditors must be able to focus on ensuring the integrity and economic substance of management’s financial statements. To get there, he said, accounting must be recognized as a profession, and not a science.³⁴ The goal Treasury Secretary Paulson suggests is an important one. More likely than not, the effort towards implementation of a “principles-based” accounting system will be “a long one.”³⁵ As noted last year by Scott Taub, the SEC’s former Interim Chief Accountant:

Unfortunately, we have gotten to a place today where there is something of an aversion to applying judgment. Often, the answer people seek is whichever one is perceived to be the safest, but those answers are not always the most transparent for investors. And we constantly get calls for every potential interpretive matter to be documented and the answer officially blessed. This, of course, leads us further into complexity and rules-based accounting, places that most of us say we don’t want to go.³⁶

Conclusion

As briefly described above, various reforms seeking to diminish the risk of liability to accounting firms are receiving attention from important industry groups and regulatory agencies. The next twelve months may see more concrete proposals emerge. Until then, the potential litigation risks to accounting firms remain.

Notes:

- 1 According to the PricewaterhouseCoopers 2005 Securities Litigation Study, securities class action cases based on restatements declined from 90 in 2002 to only 37 in 2005. Similarly, the number of SEC Litigation Releases related to new

- accounting cases declined from 61 in 2002 to 39 in 2005.
- 2 “Glass, Lewis Analyst Says Restatements On Track to Set Another Record in 2006,” *Securities Regulation & Law* (BNA) (Nov. 6, 2006).
 - 3 Examples include Arthur Andersen’s recent settlement of Enron-related class action claims for the sum of \$72,500,000.
 - 4 “Securities Class Action Case Filings: 2006, A Year in Review,” at 19 (Cornerstone Research), available online at www.cornerstone.com.
 - 5 See, e.g., *Ezra Charitable Trust v. Tyco International Ltd*, 466 F.3d 1 (1st Cir. 2006) (dismissing claims against PricewaterhouseCoopers notwithstanding Tyco’s restatement of results, and holding, inter alia, that the mere fact of restatement does not give rise a strong inference of scienter).
 - 6 *Stoneridge Insurance v. Scientific Atlanta*, docket no. 06-43 (cert. granted March 26, 2007).
 - 7 See, e.g., AICPA Ethics Ruling 94.
 - 8 Application of the Commission’s Rules on Auditor Independence—Frequently Asked Questions (December 13, 2004).
 - 9 A copy of the PEEC exposure draft is attached as Exhibit A.
 - 10 See, e.g., December 8, 2006 comment letter from Deloitte & Touche. As well, the Technical Issues Committee of the AICPA objected to the proposed deletion of its Ethics Ruling 94.
 - 11 In the wake of the original PEEC exposure draft in September 2005, various federal agencies with regulatory authority over banking and financial institutions collaborated on an “Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters.” This advisory declares it to be an “unsafe and unsound” practice for audit firms to use certain “limitation of liability” provisions in connection with audits of financial institutions.
 - 12 Interim Report of the Committee on Capital Markets Regulation (“Report”), p. 87. Relevant excerpts are attached as Exhibit B.
 - 13 Remarks of Chief Accountant Conrad Hewitt, SEC Speaks, February 9, 2007.
 - 14 “Concerned About Lawsuits Against Auditors, Top SEC Accountant Eyes Liability Safeguards” *BNA Corporate Accountability*, Vol. 4 No. 48 (December 15, 2006).
 - 15 “EU Calls for Input on Auditor Liability Caps,” *Compliance Week* (Feb. 6, 2007).
 - 16 “EU Call for Opinions on Auditor Liability Caps,” *Compliance Week* (April 2007).
 - 17 Commission of the Regulation of U.S. Capital Markets in the 21st Century: Report and Recommendations (March 2007), available on the Commission website at www.CapitalMarketsCommission.com.
 - 18 See Section 108(d) of the Sarbanes-Oxley Act of 2002 (requiring the Commission to prepare the study on principles-based accounting by July 31, 2003).
 - 19 See Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System (July 25, 2003).
 - 20 See *Sec. Reg. & L. Rep.* (BNA), (June 12, 2006); see also *Sec. Reg. & L. Rep.* (BNA) (June 19, 2006) quoting former SEC Commissioner Cynthia Glassman.
 - 21 Cynthia Glassman, former SEC commissioner, speaking at 25th Annual USC Leventhal School of Accounting SEC and Financial Reporting Institute Conference, *Sec. Reg. & L. Rep.* (BNA) (June 19, 2006).
 - 22 Remarks of Robert H. Herz, FEI Current Financial Reporting Issues Conference, (Nov. 4, 2002).
 - 23 Remarks of Linda Thomsen, SEC Director of Enforcement, 2006 Securities Regulation Institute (January 2006).
 - 24 “Standing on Principles,” *CFO Magazine* (September 1, 2006) quoting David Rickard, CFO of CVS Corp. and Financial Accounting Standards Advisory Committee (“FASAC”) member, available at http://www.cfo.com/article.cfm/7852613/c_7850066.
 - 25 *Id.*
 - 26 *Id.* (quoting Colleen Cunningham, president and CEO of Financial Executives International).
 - 27 “Standing on Principles,” *CFO Magazine* (September 1, 2006), available at http://www.cfo.com/article.cfm/7852613/c_7850066.
 - 28 “Top SEC Accountant Requests ‘Principles-Based’ Use of Rules,” *Securities Regulation & Law*, (April 3, 2006).
 - 29 “SEC’s Hewitt Says Accounting Complexity is ‘High Priority’ Issue for Agency in 2007,” *BNA Corporate Accountability*, Vol. 4 No. 48 (December 15, 2006).
 - 30 Remarks of George H. Diacont, American Institute of Certified Public Accountants conference, *Sec. Reg. & L. Rep.* (BNA) (Nov. 20, 2006).
 - 31 Remarks of John White, director of the SEC’s division of corporation finance, speaking at the Annual Securities Regulation Conference of the Practising Law Institute, *Corporate Accountability Report* (BNA) (November 17, 2006).
 - 32 “Standing on Principles,” *CFO Magazine* (September 1, 2006) quoting FASB chairman Robert Herz, available at http://www.cfo.com/article.cfm/7852613/c_7850066.
 - 33 Interim Report, *supra* note 34, at p. 80.
 - 34 “Treasury Secretary Urges Principles-Based Accounting and Internal Controls Reform,” *SEC Today* (Nov. 27, 2006).
 - 35 Remarks of SEC Chairman, Christopher Cox speaking at the SEC Historical Society Annual Meeting, *Securities Regulation & Law Report* (BNA) (June 12, 2006).
 - 36 Remarks of SEC Acting Chief Accountant, Scott Taub, speaking at the SEC Historical Society Annual Meeting, (June 6, 2006).